



The City of San Diego

Staff Report

DATE ISSUED: 7/22/2021

TO: City Council

FROM: Office Of The City Auditor

SUBJECT: Performance Audit Of The City's Major Building Acquisition Process

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Council District(s): Citywide

OVERVIEW:

In 2015, the City of San Diego (City) began a series of building acquisitions totaling more than \$230 million. Many questions have been raised about whether these acquisitions were in the best interest of the City. Overall, we found that a serious lack of policies and oversight caused the City to miss or skip key steps in the acquisition process, and allowed the prior City Administration to leave out or misrepresent key information about building acquisitions when presenting them to the City Council and the public. We made 10 recommendations to help ensure the City follows best practices when acquiring major buildings and informs the City Council and the public of all material facts. The City Administration did not agree to fully implement the majority of our recommendations.

PROPOSED ACTIONS:

Actions for this item are for the Audit Committee to accept the report and forward it to the City Council as an information item only.

DISCUSSION OF ITEM:

We conducted this audit to determine (1) if the City followed policies and best practices when acquiring major buildings and (2) if the City has sufficient governance mechanisms for oversight of major building acquisitions.

Finding 1: The prior City Administration failed to follow real estate best practices due to unclear roles and responsibilities, resulting in costs significantly exceeding estimates presented to City Council, buildings being underutilized, and the City making major investments in buildings that it did not understand the condition of.

- Key elements of due diligence were not completed because the Real Estate Assets Department (READ) believed acquiring departments were responsible for gathering this information. However, acquiring departments believed due diligence was READ's responsibility.
- The City Attorney's Office did not consistently document and present to City Council the legal risks of the contracts to acquire the buildings – for example, the 101 Ash contract that placed the responsibility on the City to understand the building's condition and limited the City's options if it discovered issues with 101 Ash later.
- The former Mayor's Office used an uncontracted advisor that had significant influence over the 101 Ash and Civic Center Plaza acquisitions. Without having a contract and obtaining the advisor's economic disclosures, the City did not ensure the advisor's loyalty. We now know the seller paid the City's advisor \$9.4 million on these two transactions.
- The City does not have a clear decisionmaker within the administration for leading acquisition decisions, beyond the Mayor. Without a lead party making decisions at the day-to-day level, responsibilities may fall through the cracks.
- Economic analyses on the costs and benefits of acquiring the buildings did not include significant information, including the costs of the lease-to-own funding structure or accurate costs of tenant improvements.
- The City addresses real estate needs as situations arise, without a central strategic plan and without requiring the establishment of a clear business case for purchasing the building.

Finding 2: The prior City Administration failed to conduct sufficient due diligence on the major building acquisitions in our scope, limiting the City's knowledge of the properties and hindering its ability to negotiate.

- READ often did not obtain independent appraisals of the properties acquired or use the appraised value in negotiations, potentially resulting in the City paying more for the buildings in several cases.
- READ did not consistently gather building condition assessments, which can help negotiations or anticipate improvement costs post acquisition.
- The City did not conduct asbestos inspections on any of the buildings prior to acquisition, as required by City policy.
- The City does not consistently conduct test fits on buildings prior to acquisition, which can lead to unforeseen and expensive renovation costs after the building is acquired.
- READ did not clearly report the true cost to acquire 101 Ash.

Finding 3: The prior City administration did not inform City Council and the public of all material facts on 101 Ash and the Housing Navigation Center, limiting the City Council's ability to perform its oversight role.

- READ misrepresented the condition of 101 Ash – staff told City Council that the building was Class A, in excellent condition, and only in need of \$10,000 of repairs when the building was classified as Class B and the City did not conduct its own assessment to ensure the building did not need more repairs. In 2020, after investing \$26 million in tenant improvements, City contractors estimated 101 Ash needs \$115 million in improvements and repairs.
- READ did not disclose that it did not perform its own due diligence of 101 Ash – it accepted all the seller's documents.
- READ did not clearly state the cost to purchase 101 Ash. The purchase price was \$92 million, not \$72.5 million as reported to City Council.
- The prior City administration did not clarify the reasons why it was not proposing to purchase 101 Ash directly – which would have reportedly saved the City \$17.2 million.
- For the Housing Navigation Center, READ relied on the seller's appraisal of the building as an indoor skydiving facility – significantly inflating its value to City Council.

- Although City staff did not provide all material facts to City Council as required by the City Charter, the City does not have an enforcement mechanism in the municipal code to take action against employees who mislead City Council.
- The prior City administration's lack of planning and rushed timelines on several deals minimized the time City Council had to evaluate major building acquisitions.

Recommendations

We made 10 recommendations to help ensure the City follows best practices when acquiring major buildings and informs the City Council and the public of all material facts. Key recommendations are listed below.

- Requiring a best practices checklist for building acquisitions. The checklist would ensure each acquisition fits into the strategic plan and has a determination of what it will be used for, funding method analysis, more accurate tenant improvement costs estimates, and written analysis flagging significant legal risks.
- Establishing clear roles and responsibilities for City departments involved in the acquisition process.
- Developing and using a strategic real estate plan for future office space usage.
- Requiring all contractors or advisors on real estate transactions have a signed contract with the City.
- Requiring READ create a due diligence checklist to ensure the City gets an independent appraisal, independent building condition assessments, environmental assessments, independent asbestos assessments, and test fits. These reports should be included in the materials that are provided to the City Council and the public prior to acquisition approval.
- Adding a section to municipal code to provide an enforcement mechanism to ensure City staff accurately represent information to City Council.
- Providing the Office of the Independent Budget Analyst with sufficient, time, information, and resources to thoroughly review the Mayor's major building acquisition proposals.

Implementing these recommendations will increase the time it takes the City to execute major building acquisitions, and could foreseeably result in the City missing out on a good investment from time to time. However, our review of the City's history in this area clearly indicates that this risk is far outweighed by the alternative – major building acquisition failures that cost taxpayers millions of dollars, disrupt City operations, and seriously damage the City's reputation in the eyes of the public.

The City Administration did not agree to fully implement the majority of our recommendations.

Fiscal Considerations:

N/A

Charter Section 225 Disclosure of Business Interests:

N/A; there is no contract associated with this action.

City Strategic Plan Goal(s)/Objective(s):

Goal 1: Provide high-quality public service

- Improve external and internal communication and coordination

Environmental Impact:

N/A

Equal Opportunity Contracting Information (if applicable):

N/A

Previous Council and/or Committee Actions:

N/A

Key Stakeholders and Community Outreach Efforts:

N/A

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